

The following discussion should be read in conjunction with the Group's consolidated financial statements and notes thereto set out in this annual report and other sections.

OVERVIEW

For the year ended 31 December 2003, the Group recorded profit before taxation of RMB765 million, representing an increase of 8.20% over that of 2002. Profit after taxation for the year amounted to RMB452 million, representing an increase of 13.85% over that of 2002. The increase in profit for the year was mainly attributable to increase in revenue generated from the Group's principal operations of 33.22% over that of the previous year.

For the year ended 31 December 2003, both basic and diluted earnings per share were RMB0.134.

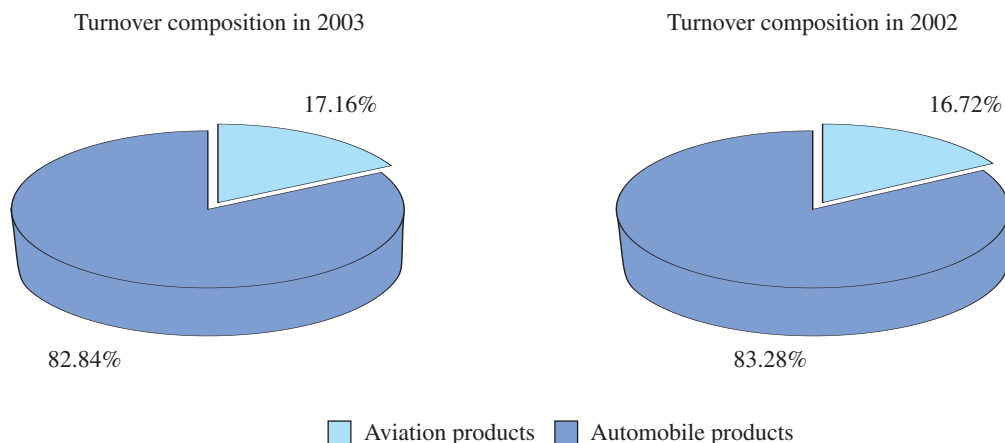
The following table shows the comparison between the consolidated operating results for the year ended 31 December 2003 and 2002:

CONSOLIDATED OPERATING RESULTS

- Consolidated profit and loss:

RMB million	Year ended 31 December		
	2003	2002	Change
Turnover	15,066	11,309	33.22%
of which: automobile segment	12,481	9,418	32.52%
aviation segment	2,585	1,891	36.70%
Cost of sales	(12,414)	(8,885)	39.72%
of which: automobile segment	(10,354)	(7,444)	39.09%
aviation segment	(2,060)	(1,441)	42.96%
Other revenues	85	51	66.67%
Selling and distribution expenses	(831)	(692)	20.09%
General and administrative expenses	(950)	(940)	1.06%
Other operating income	32	—	—
Operating profit	988	843	17.20%
Finance costs, net	(210)	(139)	51.08%
Share of results of associates before taxation	(13)	3	(533.33%)
Profit before taxation	765	707	8.20%
Income tax	(61)	(125)	(51.20%)
Minority interests	(252)	(185)	36.22%
Profit for the year	452	397	13.85%

1. Composition of turnover



The Group's turnover for 2003 increased by 33.22% from RMB11,309 million to RMB15,066 million. The increase was mainly attributable to the increase in sales volume of economy sedans and trainers during the year. The turnover of automobile products amounted to RMB12,481 million, accounting for 82.84% of the total turnover and representing an increase of 32.52% over that of 2002; turnover of aviation products amounted to RMB2,585 million, accounting for 17.16% of the total turnover and representing an increase of 36.70% over that of 2002. As shown in the chart above, the aviation products component in the total turnover in 2003 increased slightly over that of 2002.

The Group was mainly operating in the PRC from where a majority of the turnover was generated.

2. Selling and distribution expenses

Selling and distribution expenses for 2003 amounted to RMB831 million, representing an increase of RMB139 million (20.09%) over that of 2002, of which:

- (1) Vehicle transportation expenses increased by RMB98 million, which was mainly attributable to the change of transportation means from open wagons in the past to the current sealed trucks.
- (2) Sales commission increased by RMB31 million, which was mainly attributable to the increase in sales of vehicles.



3. Administrative expenses

The Group's administrative expenses for 2003 amounted to RMB950 million which was relatively stable as compared to that of 2002.

4. Operating profit

The Group's operating profit for 2003 amounted to RMB988 million, representing an increase of RMB145 million (17.20%) over that of 2002. The increase was primarily due to increase in turnover.

5. Finance costs, net

The Group's net finance cost amounted to RMB210 million, representing an increase of RMB71 million (51.08%) over that of 2002, among which exchange losses increased by RMB58 million. This was mainly because the Group had certain bank borrowings denominated in foreign currencies and such borrowings incurred exchange losses as a result of exchange rate fluctuations in the second half year of 2003.

6. Taxation

The Group's income tax for the year decreased by 51.20% from RMB125 million in 2002 to RMB61 million. The decrease was mainly because (1) certain subsidiaries of the Group were granted preferential income tax treatment as they are high-tech companies located in state economic and technological development zones; and (2) there was an increase in the Group's investment in domestically produced equipment in 2003 which entitled the Group to certain tax deduction pursuant to relevant regulations. Details of taxation are set out in note 8 to the financial statements.

7. Minority interests

The Group's minority interests for the year increased by 36.22% from RMB185 million in 2002 to RMB252 million, which was mainly attributable to the increase in profit of certain non-wholly-owned subsidiaries during the year.

- Assets, liabilities and equity

RMB million	As at 31 December		
	2003	2002	Change
Current assets	13,150	9,866	3,284
Non-current assets	7,651	6,827	824
Total assets	20,801	16,693	4,108
Current liabilities	10,657	9,184	1,473
Non-current liabilities	2,125	2,144	(19)
Total liabilities	12,782	11,328	1,454
Share capital	4,644	3,116	1,528
Reserves	380	(496)	876
Proposed final dividends	49	—	—
Shareholders' equity	5,073	2,620	2,453
Minority interests	2,946	2,745	201

As at 31 December 2003, the Group's total assets amounted to RMB20,801 million, total liabilities amounted to RMB12,782 million whereas minority interests and shareholders' equity amounted to RMB2,946 million and RMB5,073 million respectively.

1. Total assets

Total assets increased by RMB 4,108 million over that of 2002 which was mainly attributable to the increase in current assets. Current assets increased by RMB3,284 million over that of 2002; term deposits with initial term of over three months, cash and cash equivalents increased by approximately RMB1,859 million which was mainly attributable to proceeds generated from the public listing of the Company's shares; account receivables increased by RMB709 million which was mainly attributable to increase in sales; inventories increased by RMB510 million which was mainly attributable to increase in demands for raw materials resulting from expansion of production scale during the year.

2. Liabilities

Total liabilities increased by RMB1,454 million (12.84%) over that of 2002. The increase was mainly attributable to increment in account payables and short-term borrowings, among which account payables and short-term borrowings increased by RMB635 million and RMB1,095 million respectively.

3. Guaranteed and secured loans

As at 31 December 2003, the Group's bank borrowings amounted to RMB5,158 million, which included loans of RMB410 million secured by buildings, machinery and equipment with a net book value of RMB401 million.

Guaranteed borrowings amounted to RMB4,275 million, of which RMB2,679 million was guaranteed by the subsidiaries of the Group and RMB1,369 million was guaranteed by AVIC II and its subsidiaries. Guarantees provided by AVIC II and its subsidiaries are in the process of release pursuant to the undertakings made by the Company to the Hong Kong Stock Exchange on its Listing.

4. Shareholders' equity

Shareholders' equity in 2003 amounted to RMB5,073 million, representing an increase of RMB2,453 million over that of 2002. The increase was mainly attributable to issuance of new shares by the Company; thus share capital and reserves increased by RMB1,528 million and RMB876 million respectively.

5. Development costs

Since the competition in the domestic automobile market is increasingly intense, customers are more demanding on the rate of launching new models of vehicles and the level of technology of new vehicles. The Group invested more resources in developing advanced automobile products during the year and incurred research and development expenditure of RMB321 million, representing an increase of RMB97 million over that of 2002. The investment will help the Group adapt to market competition, increase its gross margin and enhance the competitiveness of its products.

6. Exchange risks

The Group had a substantial amount of loans denominated in Euro, United States dollars and Japanese Yen due to its operating needs. The Group incurred exchange losses of approximately RMB54.72 million in 2003 due to the significant appreciation in value of Euro and Japanese Yen against Renminbi during the year. Since a substantial amount of Hong Kong dollars was raised from the public offering of the Company's shares, fluctuation of exchange rate between Hong Kong dollars and Renminbi has brought about exchange risks to the Group. The Group is adopting effective measures to minimise the risks.

7. Contingent liabilities and guarantees

As at 31 December 2003, the Group had not provided any guarantees for third party and did not have any significant contingent liabilities.

- Cash Flow:

1. Liquidity and capital resources

As at 31 December 2003, the Group's cash and cash equivalents amounted to RMB2,584 million which was mainly derived from the following:

- cash and bank deposits at the beginning of the year;
- proceeds generated from the public listing of the Company's shares;
- funds generated from its operations;
- new bank borrowings.

The Group's cash flows for the years ended 31 December 2003 and 2002 were as follows:

Unit: RMB million

	2003	2002	Fluctuation (amount)	Fluctuation (percentage)
Net cash flows generated from operating activities	604	1,404	(800)	(56.98%)
Net cash flows used in investing activities	(3,638)	(2,375)	(1,263)	53.18%
Net cash flows generated from financing activities	3,145	283	2,862	1,011.31%
Increase/(decrease) in cash and cash equivalents	111	(688)	799	(116.13%)

2. Operating activities

Net cash flows generated from operating activities for the year amounted to RMB604 million, representing a decrease of RMB800 million from that of 2002. The decrease was mainly attributable to the increase in procurement activities with the increment in inventories up by RMB483 million over the same of 2002 whilst the increment in accounts payable was down by RMB334 million from the same of 2002.

3. Investing activities

Net cash flows used in investing activities for the year amounted to RMB3,638 million, representing an increase of RMB1,263 million over that of 2002. The increase was due to the following reasons: (1) term deposits with initial term over three months was up by RMB1,706 million over the same in 2002 as a result of proceeds received from the Listing being placed in term deposits; (2) increase in trading investment by RMB219 million over the same in 2002; (3) decrease in acquisition of fixed assets by RMB868 million over the same in 2002.

4. Financing Activities

Net cash flows generated from financing activities for the year amounted to RMB3,145 million, representing an increase of RMB2,862 million over that of 2002. The increase was mainly due to receipt of proceeds from the Listing amounting to RMB2,167 million, net cash of RMB241 million generated from issuance of additional shares by a subsidiary and borrowings increased by RMB727 million.

As at 31 December 2003, the Group's total borrowings amounted to RMB5,370 million, of which current borrowings, non-current borrowings due within one year and non-current borrowings due over one year amounted to RMB3,784 million, RMB200 million and RMB1,386 million respectively.

The Group's non-current borrowings are repayable as follows:

	RMB million
Within one year	200
In the second year	714
In the third to fifth year	660
After the fifth year	12
	<hr/>
Total	1,586
	<hr/> <hr/>

As at 31 December 2003, the Group's bank borrowings amounted to RMB5,321 million with an average interest rate of 4.65%, representing 99.09% of the total borrowings. Other borrowings amounted to RMB49 million with an average interest rate of 1.85%, representing 0.91% of the total borrowings.

As at 31 December 2003, the Group's borrowings denominated in foreign currencies amounted to RMB938 million, representing 17.5% of the total borrowings. As at 31 December 2003, borrowings denominated in United States dollars, Euro and Japanese Yen amounted to US\$33 million, Euro 33 million and Yen 4,234 million respectively.

- Gearing Ratio

As at 31 December 2003, the Group's gearing ratio was 26% (2002: 28%), which was arrived at by dividing the total borrowings by total assets as at 31 December 2003.

SEGMENT INFORMATION

The Group's principal operations are divided into two segments, namely the automobile segment and the aviation segment.

AUTOMOBILE SEGMENT

Major statistics of automobile operation

	Year ended 31 December							
	2003				2002			
RMB million	Sales volume (units)	Sales revenue	Cost of sales	Gross margin (%)	Sales volume (units)	Sales revenue	Cost of sales	Gross margin (%)
Automobile products in total	—	12,481	10,354	17.04%	—	9,418	7,444	20.96%
Entire vehicles in total	326,814	10,700	8,874	17.07%	320,039	9,020	7,101	21.27%
Mini-vans and mini-trucks	253,466	6,779	5,620	17.10%	286,207	7,211	5,563	22.85%
Economy sedans	73,348	3,921	3,254	17.01%	33,832	1,809	1,538	14.98%
Vehicle engines	90,275	1,304	1,065	18.33%	58,870	385	330	14.29%
Others	—	477	415	13.00%	—	13	13	—

ANALYSIS ON THE AUTOMOBILE INDUSTRY

Review on the PRC automobile market in 2003

Rapid growth in sales of vehicles recorded in 2002 in the PRC continued in 2003. Total sales volume amounted to 4,390,000 units, representing an increase of 34% over that of 2002. China has been the fastest growing automobile market in the world for two successive years. The PRC has surpassed France to become the fourth largest automobile production nation in 2003, after the United States, Japan and Germany.

Sales volume of vehicles in China in 2002 and 2003

(`000 units)	2003	% increase from last year	2002	% increase from last year
Sedans	1,972	75	1,126	56
Trucks	1,211	10	1,077	31
Vans	1,208	15	1,045	25
Total	4,391	34	3,248	37

Source: China Automotive Industry Newsletter of Production and Sales

Leveraging on the strong growth of the economy, the steady increase in personal income and the general reduction in selling prices, sedans achieved the swiftest growth within the PRC automobile industry in 2003. Output of sedans amounted to 2,018,900 units, representing an increase of 917,000 units (83.25%) over that of 2002 whilst sales of sedans amounted to 1,971,600 units, representing an increase of 75.28%. Capitalising on the continuous launch of new products, economy sedans priced at less than RMB100,000 became the most active and popular segment in the sedan market, although price competition in this segment was rather intense.

Affected by the outbreak of SARS and the safety regulation relating to vehicle frontal crash, the PRC mini-van market was sluggish in 2003 with an aggregate of 695,400 units of mini-vans sold, representing only a slight increase of 10.12% over that of 2002.

The sales of mini-trucks decreased to 137,200 units in total, representing a decrease of 6.19% as compared with that of 2002.

PROSPECT OF PRC AUTOMOBILE MARKET FOR 2004

We expect that the PRC automobile industry will continue to grow in 2004. According to a preliminary forecast made by the China Association of Automobile Industry (中國汽車工業協會), the total output of vehicles will be 5,100,000 to 5,340,000 units, among which trucks, vans and sedans will account for 1,310,000 to 1,370,000 units, 1,290,000 to 1,350,000 units and 2,500,000 to 2,620,000 units respectively. In view of the continuous development of new models, competition in the middle-range and high-end sedan market will be even more intense in 2004. Meanwhile, the competition between economy sedans with lower



prices and cost of usage will also be more intense. One noticeable change in competition in the current automobile industry is the shift from price competition solely to competition on all fronts covering brand recognition, speed of launching new models, quality of after-sales services and strength in procurement and sales network. It is expected that in 2004, the State will strongly promote the structural adjustment and reorganisation of the automobile industry through the implementation of industrial policies. The entry barrier to the industry would be raised by regulating investments. As such, automobile manufacturers with research and development expertise and scale production capability will benefit from the State's policies relating to the automobile industry.

Following the implementation of mandatory regulations by the State relating to environmental protection, road safety and China Compulsory Certification, and the lowering of import tariff and the abolition of quota on imported vehicles, all automobile manufacturers are expected to encounter even more intense competition in terms of pricing, performance, quality, features and services of their products in order to maintain and increase their market shares.

REVIEW ON THE GROUP'S AUTOMOBILE BUSINESS IN 2003

In face of intense market competition, the Group has adopted certain product structure adjustments with more resources being allocated to the economy sedan market which grew more rapidly. During 2003, two new models of sedans, namely "Hafei Lobo" and "Changhe Ideal" were launched. The Group has expanded its business lines from principally producing mini-vans and mini-trucks to producing economy sedans, mini-vans and mini-trucks.

In 2003, the Group sold a total of 327,000 units of vehicles and produced a total of 426,000 units of vehicle engines. Of the vehicle engines, 90,300 units were sold to outside manufacturers, and the rest of them were deployed internally by the Group.

1. Adjustment to product combination achieved remarkable results and proportion of economy sedans increased significantly

A total of 73,300 units of economy sedans were sold for the year, representing an increase of 116.86% over that of 2002, and exceeded the average growth rate in sales volume of sedans of 75.28% for the nation. Currently, the Group is selling five models of economy sedans, which accounted for 22.4% of the Group's output and sales of vehicles in 2003 when compared with 10.6% in 2002.

A total of 225,600 units of mini-vans were sold during the year, representing a decrease of 9.94% from that of 2002.

A total of 27,900 units of mini-trucks were sold during the year, representing a decrease of 21.85% from that of 2002.

Although sales volume of mini-vans and mini-trucks dropped, sales revenue of the Group's automobile products, instead of decrease, increased by 32.52%, which was mainly due to the change in product mix.

Decrease in sales of mini-vans and mini-trucks was mainly attributable to the following factors:

- (1) mini-vans which did not meet frontal crash requirements in accordance with the new safety regulation implemented by the State since 1 June 2003 ceased to be sold therefrom;
- (2) SARS broke out in the PRC in the 1st half of 2003. The markets in which the Group was actively involved were severely affected by SARS, hence the sales of the Group's mini-vans and mini-trucks.
- (3) The cessation of provision "automobile financing and insurance" by the insurers had adversely affected the purchasing power of customers;
- (4) Demand for mini-trucks in the PRC generally decreased, so was the sales of the Group's mini-trucks;
- (5) More efforts were devoted by the Group to adjusting the automobile products combination during 2003, particularly in economy sedans which had a higher gross margin, and thus a comparatively smaller amount of investment was put in mini-vans and mini-trucks.

2. Pace for launch of new products in the market accelerated

The Group launched the largest number of new vehicle models in 2003. Five new models were produced and launched to the market, including two models of economy sedans, namely "Hafei Lobo" and "Changhe Ideal", and three models of mini-vans, namely "Hafei Minyi", "Changhe Haitun" and "Changhe Haixiang". Sales of new models accounted for 18% of the total sales volume of the Group's vehicles. Continuous launch of new vehicle models in the market has laid a solid foundation for future development.

3. Output of vehicle engines broke through 400,000 units

Growth of the Group's vehicle engines maintained at a fast pace. While ensuring sufficient vehicle engines were produced for internal use, more efforts were put in developing the market for vehicle engines outside the Group. A total of 426,000 units of vehicle engines were produced during the year, representing an increase of 28.3% over that of 2002.

4. Technical improvement of production lines for economy sedans and engines was completed and the production lines were put into operation

Construction of production lines for economy sedans namely “Hafei Saima” and “Hafei Lobo” was completed in 2003 whilst “Changhe Ideal” economy sedan was launched at the end of 2003. These assured the rapid growth of economy sedans in 2003. Production lines for “DA468 engine” and “Dongan 4G1 engine” for the use by the models above commenced commercial production after the completion of their construction. These production lines played an important role to enhance the technological level and scale of automobile production.

SALES REVENUE

The Group’s sales of automobile products for 2003 amounted to RMB12,481 million, of which the sales of vehicles accounted for RMB10,700 million, representing an increase of RMB1,680 million over that of 2002. The increase was mainly attributable to the strong increase in sales volume of economy sedans of higher unit selling prices. As such, the Group’s sales revenue from vehicles for 2003 increased by 18.6% even though the total sales volume remained stable.

The majority of vehicle engines produced by the Group was used for the Group’s own vehicle production. Total production volume of vehicle engines for 2003 amounted to 426,000 units, of which 90,300 units were sold to external manufacturers. Since the Group began to focus on developing external markets for its vehicle engines in 2003, external sales of vehicle engines for 2003 increased by 238.70% from RMB385 million in 2002 to RMB1,304 million.

COST OF SALES

Cost of sales of the Group’s automobile products for 2003 amounted to RMB10,354 million, of which cost of sales of vehicles increased to RMB8,874 million from RMB7,101 million in 2002. The increase was mainly attributable to such factors as increase in sales of economy sedans, increase in sales of vehicle optional accessories and increase in purchase price of raw materials etc.

Cost of sales of the Group’s vehicle engines for 2003 increased to RMB1,065 million from RMB330 million in 2002. The increase was mainly attributable to (1) increase in sales volume; (2) the higher unit prices of the engines sold in 2003 as most of them were electronic fuel injection engines. Electronic fuel injection engines have more advanced technology and less pollution than carburetors and are therefore of higher unit costs.

GROSS MARGIN

Gross margin of the Group’s automobile products for 2003 was 17.04%, representing a decrease of approximately 4 percentage points from that of 2002. The decrease was mainly attributable to the appropriate price adjustment made by the Group to its mini-vans and mini-trucks in view of price competition from its competitors, as well as price increase in raw materials and spare parts. Although the Group adopted certain measures to lower its costs, cost of sales per unit of mini-vans and mini-trucks still increased because of the deployment of more expensive electronic fuel injection engines in such vehicles. In spite of this, gross margin of the Group’s economy sedans increased by approximately 2

percentage points over that of 2002; this was mainly attributable to increase in use of domestic raw materials and spare parts as well as increase in sales volumes.

Gross margin of the Group's vehicle engines for 2003 was 18.33%, representing an increase of approximately 4 percentage points over that of 2002. The increase was mainly attributable to the economies of scale resulting from increase in production volume and sales of engines in 2003.



AVIATION SEGMENT

Major statistics of aviation operation

RMB million	Year ended 31 December							
	2003				2002			
	Sales volume (units)	Sales revenue	Cost of sales	Gross margin	Sales volume (units)	Sales revenue	Cost of sales	Gross margin
Aviation products in total	67	2,585	2,060	20.31%	49	1,891	1,441	23.80%
Helicopters	22	885	694	21.58%	28	826	661	19.98%
Trainers	35	555	459	17.30%	19	272	209	23.19%
General purpose aeroplanes	10	43	48	(11.63%)	2	26	28	(7.69%)
Aviation parts and components	—	959	748	22.00%	—	663	470	29.11%
Others	—	143	111	22.38%	—	104	73	29.81%

AVIATION PRODUCT MARKET

The PRC economy is currently in a period of stable growth. The State maintains its policy of increasing domestic demand and continues to implement proactive financial policies and sound monetary policies. The national economy will continue to grow steadily through the efforts to be made on the development in western China and revitalisation of traditional and industrial bases in Northeast China. The macro economy, in which the Group forms a part, remains favourable. It is anticipated that the aviation transport market will grow in line with the GDP. Accordingly, the demand for aviation products from aviation services providers and government departments will also grow in parallel with the development of the national economy, and thus stimulating the development of the civil aviation product manufacturing industry. According to the analysis in the "Annual Report on the PRC Civil Aircraft Market Estimation" (中國民用飛機市場預測年報) issued by the China Aviation Industry Development and Research Center, in view of the continuous growth of the PRC economy, rapid development of tourism, implementation of strategies in respect of the development in western China and comprehensive reforms on the civil aviation industry, the PRC aviation transport market in future will grow at a rate more rapid than the average development rate of the global aviation transport in the corresponding period, and is the

market with the most potential to grow in the world. Leveraging on advanced technology and well-developed products, famous aviation product manufacturers in the world are eager to enter the PRC market. The Group must compete for orders even though there is a potential market for its aviation products.

I. Civil helicopter market

Civil helicopter market in the PRC has relatively large market potential. Deployment of civil helicopters in different economic and social activities is increasingly popular in the PRC. Demand for helicopters is apparent in sectors like the police, customs, oil production, transportation, electricity, forestry, environmental protection, urban planning, tourism, scientific research and investigation, salvage, medical assistance, emergency rescue and agriculture. According to a forecast made by China National Aero-Technology Import and Export Corporation, demand for civil helicopters in the PRC will reach 900 units by 2015. In addition, with development of international markets, there is interest for the Group's helicopters from countries in Asia, Africa and South America. The Group is devoted to enhancing the productivity of helicopters, upgrading existing models, and developing new models to increase sales of helicopters.

II. Regional jet market

According to the analysis in the "Annual Report on the PRC Civil Aircraft Market Estimation" (中國民用飛機市場預測年報), number of passenger aircraft in the PRC will reach 1,762 units in the next twenty years. As a result of the reorganisation of domestic airlines, number of regional jets will increase significantly. Demand for regional jets with less than 70 seats will reach 575 units. The Group is currently soliciting more orders for regional jets.

III. Trainer and general purpose aeroplane market

Domestic demand for trainers is relatively stable. The Group is developing new models of trainers and proactively developing international markets. Demand for general purpose aeroplanes is increasing. The Ministry of Agriculture of the PRC has expressly requested the Group to provide agriculture aircraft; however, the actual demand has



yet to be confirmed. Although the General Aviation Flight Control Regulations was promulgated in 2003, restriction on the use of low altitude airspace has not been fully alleviated. Whether the restriction on the use of low altitude airspace will be further relaxed will have direct impacts on market demand for general purpose aeroplanes.

IV. Aviation parts and components and sub-contracting business

The development of the aviation manufacturing industries in the world created huge market demand for the aviation parts, components and sub-contracting business. Leveraging on the opportunity when famous international manufacturer engaged in aviation products adjust their production structure, the Group will proactively tap opportunity as to the global supply chain of aviation products upon its strengths in advanced manufacturing technologies and lower labour costs. With the increase in sales of aviation parts and components over that of 2002, the Group will further adjust its product combination to increase its market share in sub-contracting business.

RESEARCH AND DEVELOPMENT AND PRODUCTION OF AVIATION PRODUCTS BY THE GROUP IN 2003

ERJ145, turboprop regional jet jointly assembled by the Group and Embraer-Empresa Brasileira de Aeronautica S.A. had completed its maiden flight successfully in Harbin, the PRC in 2003. It is the first regional jet of world class technology standard domestically developed in the PRC. It marks a good beginning of active cooperation with international counterparts and co-development with the world's civil aircraft manufacturing industry by the PRC aviation industry.

The H425 helicopter developed by the Group had also completed its maiden flight successfully in 2003. It is by far the most technologically advanced civilian helicopter developed domestically. Its performance is up to international standard.

In addition, the upgraded Z-11 had its first flight completed successfully. This upgraded model is equipped with a new engine based on Z-11. Its communication, control and display systems and structures have also been upgraded. An airworthiness certificate has been issued by the PRC aviation authority in respect of this model.

The successful first flights of the two models of helicopters aforesaid have provided more choices in respect of helicopter models in the civil helicopter market.

The Group is now developing a new model of trainer for export.

SALES REVENUE

The Group's sales of aviation products for 2003 amounted to RMB2,585 million, representing an increase of RMB694 million (36.70%) over that of 2002. Sales of aircraft amounted to RMB1,484 million, representing an increase of RMB360 million (32.03%) when compared with RMB1,124 million of 2002.

Sales of aviation parts and components amounted to RMB959 million, representing an increase of RMB296 million (44.65%) over that of 2002.

COST OF SALES

Cost of sales of the Group's aviation products for 2003 increased by RMB619 million to RMB2,060 million as compared to that in 2002, representing an increase of 42.96%. The increase was mainly attributable to (1) increase in sales volume and hence the cost of sales; (2) increase in unit cost due to the price increase in domestically-procured raw materials; (3) price increase in imported spare parts.

GROSS MARGIN

Gross margin of the Group's aviation products for 2003 was 20.31%, representing a decrease of approximately 3.5 percentage points from that of 2002. The decrease was mainly attributable to price increase in domestic-procured raw materials and imported spare parts.

ORDERS FOR AVIATION PRODUCTS

As at the date of this report, the Group has received preliminary orders of 28 helicopters, 22 trainers, 4 general purpose aeroplanes and 6 regional jets. The Group is proactively soliciting more aircraft orders.

STRATEGIC MEASURES TO BE ADOPTED BY THE GROUP IN 2004

1. Automobile products:

- i. In light of the decrease of gross margin resulting from price competition, measures to improve the gross margin will be reviewed.
- ii. The construction of a vehicle and engine research and development centre will be accelerated in order to further enhance the Group's own development capability in respect of vehicles and engines. The Group will keep launching products deploying its proprietary intellectual property rights and brand names on the basis of joint design and development with famous international vehicle design companies.
- iii. The cooperation with famous international automobile manufacturers in respect of launching new models and capital investment will be enhanced in order to further increase the market share of the Group's automobile products.
- iv. Automobile product design will be standardised gradually and on this basis, procurement channels of automobile production will be integrated step by step. Production plants of entire vehicles and engines will be consolidated to further lower the production cost.
- v. More emphasis will be put on the development of a marketing and sales network. On the basis of consolidation



of the original sales network, new sales and after-sales services centres will be established or enlarged in some districts. The Group will focus on consolidation of the existing markets. It will also devote efforts to developing markets in small and medium sized cities as well as rural markets.

- vi. Development and production of new models of vehicles and engines will be accelerated.

2. Development of aviation products:

- i. More emphasis will be put on major markets and customers by strengthening the Company's marketing capability.
- ii. Efforts will be put in developing potential markets and procuring groups of customers in light of the significant strategy of the State to develop the Central and Western China as well as the potential of domestic regional jet, general purpose aeroplane and helicopter markets.
- iii. Cooperation with international counterparts will commence, particularly in the production of helicopters, improving and upgrading existing models and joint research and development of new models of helicopters.
- iv. The Group will develop new customer base for regional jets.
- v. New models of advanced trainers for export will be developed by way of cooperation with other manufacturers.
- vi. The Group will seek to increase overseas market share for helicopters and trainers by putting more efforts in developing the international market.



3. Enhancement of corporate reforms:

Capitalising on the State's policy on supporting reforms on large and medium-sized corporations and revitalising the traditional industrial bases in the Northeast China, the Group will improve the organisational structure of each subsidiary and the human resources system and reduce the size of staff to further enhance the Company's productivity.

USE OF PROCEEDS

Since the Company has been listed for a relatively short period of time, proceeds of the Listing have not been utilised. As at 31 December 2003, net proceeds (after deducting the intermediary fees and relevant fees), amounting to RMB1,870 million, were placed in time deposits in banks in the PRC. The Company will utilise the proceeds to expand the Group's production capacity in vehicles and vehicle engines and develop new models of vehicles, to improve and upgrade helicopters and develop new models of helicopters, to improve and upgrade trainers and general purpose aeroplanes,

to research and develop new models of trailers, to develop regional jets, and for establishment of a new automobile and helicopters R&D center etc..

EMPLOYEES OF THE GROUP

As at 31 December 2003, the Group had 33,293 employees.

Employees analysed by functions

	Number of employees	Percentage to total employees (%)
Vehicles and engines	16,793	50.44%
Civil aviation	14,084	42.30%
Other activities	2,416	7.26%
Total:	33,293	100%

For the year ended 31 December 2003, staff costs of RMB903 million in aggregate were incurred by the Group for its employees.

REMUNERATION OF STAFF

The Group's remuneration system is determined by the remuneration committee under the board of directors based on fair and reasonable principles which are similar to those available in the market. Remuneration of employees comprises of basic salary, contribution to a housing fund, contributions to pension plans and benefits in kind. The Group will also, in its discretion, pay year-end bonus to employees according to their respective performance. Certain of the Company's directors and senior management and subsidiaries' senior management are also entitled to participate in an interim performance incentive programme and a share appreciation rights plan. Certain core technicians of the Company and certain supervisors and department heads of the Company's headquarter are also entitled to participate in the share appreciation rights plan.

TRAINING FOR STAFF

The Group expects high level of knowledge and skill in respect of the automobile manufacturing industry and the aviation manufacturing industry from its staff. Therefore, implementation of comprehensive staff training is a key to the Group's continuous development. Accordingly, the Group will continuously review its existing staff training system.

The Group provides special training courses, seminars on strategic management, human resources management, financial management for its senior management. Trainings relating to all kinds of professional skill and management technique are also provided to all professional departments of the Group's headquarter and the business departments of its subsidiaries. On-the-job training including that relating to corporate culture, management concept and management standardisation is also provided to new staff.

The Group also provides overseas training to the management officers and technicians by cooperation with international partners. The employees, through the training, are able to continuously acquire new knowledge to enhance their abilities. This will thus enhance the Group's competitiveness to adapt to the ever-changing market.

MISCELLANEOUS

In order to strengthen its core operations, the Group had disposed Hafei Machinery to a third party. Details of which are set out in note 37(d) to the financial statements.

Since February 2004, the Company's H Shares have been included as a constituent stock of the MSCI Global Value Index and Heng Seng China Enterprises Index.

